The ECJ in 'Estro/Smallstep': The End of Pre-packs as we Know Them?

20 Jul 2017

Frederik De Leo

In its preliminary ruling of 22 June 2017, the ECJ held that the Dutch pre-pack does not come under the derogation in Article 5(1) of Directive 2001/23.The reasoning of the ECJ will have important consequences for the pre-pack-practice and (draft) legislation in all EU Member States.

Background: Project Butterfly

In November 2013, Estro Groep BV (the largest childcare company in the Netherlands) entered into financial distress. Since plan A, ie consulting its lenders and principal shareholders in order to obtain further financing, was unsuccessful, 'Project Butterfly' came into force. Under Project Butterfly, a significant part of Estro Group would be transferred pursuant to a pre-pack: 243 centers out of 380 would be saved and 2,500 employees out of 3,600 would keep their job.

On 10 June 2014, at the request of Estro Group, a prospective insolvency administrator was appointed by the District Court, Amsterdam to implement Project Butterfly. Whilst implementing Project Butterfly, Estro Groep only contacted H.I.G. Capital, a sister company of its principal shareholder, Bayside Capital, as a potential buyer. No other option was explored. On 20 June 2014, a limited liability company, Smallsteps BV, was created in order to carry out Project Butterfly.

On 5 July 2014, Estro Group was declared insolvent. On that same day (right after the declaration of insolvency), the contract of the pre-packaged insolvency sale was signed by the insolvency administrator and Smallsteps. On 7 July 2014, the insolvency administrator dismissed all Estro Group employees. Smallsteps subsequently offered a new contract of employment to nearly 2,600 staff employed by Estro Group.

The Federatie Nederlandse Vakvereniging (‘*FNV*’), a Dutch trade union organization, and four joint applicants (dismissed employees), brought an action before the referring court. The District Court, Central Netherlands decided to stay the proceedings and to refer to the Court of Justice for a preliminary ruling. The main question was whether Directive 2001/23 must be applied in the event of a transfer of an undertaking as part of a pre-pack, as has been developed in practice in the Netherlands.

The Opinion of Advocate General Mengozzi

In his opinion, AG Mengozzi argued that the protection scheme laid down in Articles 3 and 4 of Directive 2001/23 applies to the Dutch pre-pack procedure. In coming to his conclusion, the AG analyzed Article 5(1) of that Directive, which reads as follows:

‘Unless Member States provide otherwise, Articles 3 and 4 shall not apply to any transfer of an undertaking, business or part of an undertaking or business where the transferor is the subject of bankruptcy proceedings or any analogous insolvency proceedings which have been instituted with a view to the liquidation of the assets of the transferor and are under the supervision of a competent public authority (which may be an insolvency practioner authorised by a competent public authority)’.

The AG started with two (preliminary) remarks concerning this Article.

First, the Netherlands did not adopt a specific provision which provides ‘*otherwise*’ than in Article 5(1). Therefore, the exception laid down in Article 5(1), which must be interpreted strictly, is relevant in the present case.

Second, Article 5(1) represents the codification of principles laid down in the case-law concerning Directive 77/187 (the predecessor of Directive 2001/23) developed by the Court: Abels; d’Urso and Others; Spano and Others; and Dethier Equipement.
In *d’Urso and Others*, the Court expressly stated that *‘[g]iven all the considerations set out in the judgement in the Abels Case, the decisive test is therefore the purpose of the procedure in question’* (later affirmed in *Spano and others*). If the *objective* of the procedure is to *liquidate* the debtors’ assets in order to satisfy collectively the creditors’ claims, then the transfers effected under that procedure are excluded from the scope of Directive 77/187. On the other hand, if the *objective*of that procedure is also to *keep* the undertaking in business, the social and economic objectives thus pursued cannot explain nor justify the circumstance that, when the undertaking is transferred, its employees lose the rights which the directive confers on them.
In *Dethier Equipement*, the Court fine-tuned its test: apart from the criterion of the purpose of the procedure, *‘account should also be taken of the form of the procedure in question, in particular in so far as it means that the undertaking continues or ceases trading, and also of the objectives of Directive 77/187’*.

When considering the *objective* of the Dutch pre-pack procedure, the AG finds that there is no doubt that the pre-pack procedure, taken as a whole, is aimed at transferring

the undertaking (or its still viable units) in order to *restart* the business without any interruption, immediately after the declaration of insolvency. The pre-pack is merely a '*technical insolvency proceeding*'.

When considering the specific *form* of the Dutch pre-pack procedure, the AG finds many differences compared with the 'traditional' insolvency procedure. First, the Dutch pre-pack is always initiated by the debtor while an insolvency procedure may be initiated by different stakeholders. Second, the Dutch preparatory phase is entirely informal in nature. In particular, it is clear that the insolvency administrator and the court have much less influence in the case of the 'special' procedure leading to the conclusion of a pre-pack than in the case of the 'traditional' procedure for insolvency aimed at liquidating the transferors' assets.

The Court's judgment

As I had predicted in a previous post on the Corporate Finance Lab, the ECJ has followed the Opinion of AG Mengozzi: employees who are confronted with a pre-pack procedure must be protected *cf* Articles 3 and 4 of Directive 2001/23.

When considering the *objective* of the Dutch pre-pack procedure, the ECJ stated that the real objective of the pre-pack procedure is the preservation of the business. The fact that creditors will receive more under a pre-pack procedure than under a liquidation procedure does not alter the fact that the main goal of the pre-pack procedure is the preservation (and not the liquidation) of the business.

When considering the *form* of the Dutch pre-pack procedure, the ECJ repeats the arguments which were already expressed by the AG: there is no real supervision of a competent public authority.

The impact of the judgement: Belgium as a case study

For the time being, the Belgian minister of Justice has decided to withdraw its legislative proposal concerning the pre-pack. I am inclined to say that was a smart move.

First of all, the explanatory memorandum states the following: *'[c]et article suit le modèle qui sera également prévu dans la future législation néerlandaise. Il est certain que la finalité d'une telle procédure est de préserver la continuité de l'entreprise ou des activités'*. The ultimate *objective* of the Belgian pre-pack is thus not liquidation, *ie*,'*maximizing the payment of the creditors' collective claims*'. To the contrary: preservation of the business is the goal. As a consequence, the Belgian draft legislation would not have passed the first part of the test (*liquidation objective*).

Second, the specific *form* of the pre-pack differs from the form of a 'normal' liquidation procedure. Similar to the pre-pack practice in the Netherlands, the Belgian

draft legislation stipulated that only the debtor (and thus no other stakeholders, such as creditors) can initiate the pre-pack procedure. Although the Belgian pre-pack procedure would not be informal – since there would be formal legislation –, the prospective insolvency administrator and the prospective *juge-commissaire* would have much less influence than the insolvency administrator and *juge-commissaire* in a traditional liquidation procedure. After all, during the preparatory phase, the debtor (read: the management, controlled by the majority shareholders) stays in control: the debtor asks for a pre-pack procedure, conducts the negotiations, ultimately adopts the necessary decisions and can even fire the prospective insolvency administrator. In the second phase of the pre-pack procedure, *ie* the "normal" liquidation procedure, the prospective insolvency actors become by default – although not always (for my critical reflections on this, see here) – the 'normal' insolvency actors. Since they have to act quickly (to keep the going concern value intact), they will mostly approve the pre-packaged insolvency sale without any further investigation (Note that the ECJ thinks the same, §56-57). After all, the ones who need to be monitored become the monitors… For these reasons, I think the Belgian legislator would have had a hard time proving they passed the second part of the test (*form of liquidation procedure*).

A longer version of this post has appeared here.

Frederik De Leo is a PhD Candidate in Insolvency Law at the University of Leuven.